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SUBJECT: 2009-2010 GOI BUDGET APPROVED

Summary:

¶1. (U) Three and a half months after being introduced, the 2009-2010 GOI budget was approved by a majority of 58 Members of Knesset (MK)--versus 36 MKs against--in final readings in the Knesset on July 15. The budget framework includes deficit ceilings of six percent of GDP in 2009 and 5.5 percent of GDP in 2010, and a one-time expenditure increase of 1.35 percent above the 1.7 percent expenditure ceiling which has been anchored in legislation since 2007. The Prime Minister paved the path to final budget approval by withdrawing a proposal to levy VAT on previously un-taxed fruits and vegetables--one of the most controversial items of the budget process. A number of economists and economic commentators view the budget favorably given the economic slowdown, and find the increase in the deficit acceptable. However, others believe that a deficit of 5.5-6.0 percent is too high for Israel, and are concerned about the ability of the government to return to the stringent declining deficit path that it had previously set. Although the final budget is viewed as better than the original budget proposal--which included contentious cuts in benefits to the elderly, children, and Holocaust survivors-- there is no shortage of criticism among economists on how the budget process was handled, and concerns about what this means for the ability of the Finance Ministry to function effectively in the future. END SUMMARY.

THE FISCAL FRAMEWORK*BOTH GOOD AND BAD

¶2. (U) The main components of the budget include: 31.5 percent for debt repayment; 29.8 percent for transfer payments in 2009 (27.8 percent in 2010); 17.9 percent for civilian expenditures; and, 16.2 percent for defense expenditures in 2009 (17.2 percent in 2010). The largest ministry budgets include: Defense - NIS 48 billion (USD 12.3 billion); Education -- NIS 30.3 billion in 2009 (USD 7.8 billion) and NIS 32.4 billion in 2010; and the Ministry of Health -- NIS 19.2 billion in 2009 (USD 5 billion), and NIS 21.4 billion in 2010. There has been an increase in the education budget of about NIS 2.8 billion since 2008 in order to implement a multi-year education reform plan, as well as to improve teachers, wages. These increases also reflect a coalition agreement to augment budgets for religious schools.

¶3. (U) The budget framework includes deficit targets of six percent of GDP in 2009 and 5.5 percent in 2010. Several economists view the deficit ceiling of six percent as reasonable given the economic situation, and in line with automatic stabilizers during times of economic slowdown. The general assessment is that provided that there will not be a collapse in tax revenues, the government will be able to meet its target. Depending on the extent of economic recovery,

the deficit could even fall below the target in 2010. The Bank of Israel predicts the 2009 deficit to be in the 5.0-5.5 percent range. Echoing other commentators, Dr. Michael Sarel, Chief Economist at Harel Finance, believes the deficit ceilings of six percent and 5.5 percent are too high and are unjustified. He believes that such levels could work in the U.S. where they might reduce the impact of the recession, but are not appropriate for Israel. He is also concerned about whether the government will be able to return to fiscal restraint in 2011 and how the GOI will meet the declining deficit path that it set for itself after the current period.

(NOTE: This former framework included a gradual decline from three percent in 2011 to one percent in 2014. END NOTE).

¶4. (U) The current government expenditures-to-GDP ratio of approximately 43.4 percent in 2008 is close to the OECD country average of 42.6 percent. Thanks to strong economic growth over the past five years, Israel's expenditures-to-GDP ratio has declined from the 52 percent level of 2003. Bank of Israel economists view the current level of expenditures-to-GDP as sustainable and do not see a need to reduce it further. Significant amounts of spending are locked in for defense and debt servicing, so further cuts would make it difficult for the government to maintain adequate health, education and welfare services.

¶5. (U) The arrangements bill--Israel's budget policy document--also included increases in child allowances and elderly allowances, in order to somewhat offset the negative implications of the economic slowdown; additional supplements for companies and employers in financial distress; increased National Insurance Institute payments for individuals earning between NIS 35,000) NIS 70,000 a month (USD 7,700 to USD 18,000 a month); more generous unemployment benefits; increased funds for R&D and the Chief Scientist; assistance for small and medium companies; and export and credit assistance. Attempts to expand the Israeli version of the Wisconsin Plan nationwide, as well as negative income tax have been delayed, due to some political disagreements over implementation of the Wisconsin Plan. (NOTE: A local version of the Wisconsin Plan⁸ started operating in the summer of 2005 as part of then Finance Minister Netanyahu's plan to encourage movement away from allowances and to a culture of work. END NOTE).

¶6. (U) Noticeably absent from the budget were Prime Minister Netanyahu's three large planned institutional reforms: that of the Israel Land Authority, the electricity sector, and the ports. These will be handled outside the budget framework. Given their complex nature and the structure of the governing coalition, most analysts doubt any of the three will be enacted. Not much is left of the Israel Lands Authority reform, as it has gone through various changes on the way to Knesset approval. In terms of the other two reforms) electricity and ports--there are differing views on their importance, ability to be executed, and cost effectiveness given the labor unrest that would take place on the road to reform.

TAX REDUCTIONS AND THE PM'S ECONOMIC PLANS

¶7. (U) Tax reductions are a central element of Prime Minister Netanyahu's economic world view, and were a large part of his 2003 economic recovery plan as Finance Minister. At the time, economists felt that such tax reductions were important, but today some politicians and economists see Netanyahu as obsessed⁸ with tax cuts. The original 2009-2010 economic plan included a section intended to continue reducing income and corporate tax until 2016, extending the current tax reform plan that was to end in ¶2010. This would have brought the highest marginal income tax to a level of 39 percent in 2016, and corporate tax to 18 percent, compared with their current rates of 46 percent for individuals and 26 percent for corporate tax. However, from the time it was announced, this plan had many critics since Israel's taxes*particularly its income taxes*are deemed to

be at acceptable levels compared to other similar economies, and because of the already sharp decline in tax revenues. For instance, S & P in its July 16 rating update notes that government revenues are falling in all major categories to a forecasted 29 percent of GDP in 2009, from an average of 33 percent of GDP over the past five years. The GOI reached a compromise on taxes whereby there will be additional decreases of one percent each in 2009 and 2010*instead of the two percent each year originally proposed. As for corporate income tax, there will be a one percentage point decline in 2010 to 25 percent, in accordance with the previous tax reform plan.

18. (U) In contrast, there were discussions regarding a drought tax in light of the dire water situation. Since the agriculture sector has a strong lobby, it was clear early in the budget process that there would not be additional concessions from industry. Instead, the GOI decided to impose a tax on households for using more than a specific quantity of water based on the number of individuals in the household. The levy will remain in effect through winter (rain season), but the quota will then be increased. This tax is estimated to provide revenues of between NIS 800 million (USD 200 million) to NIS 1.2 billion (USD 300 million) until the end of 2010.

19. (U) Similarly, the GOI proposed to begin collecting VAT on fruits and vegetables. Though seemingly innocuous, this proposal drew tremendous attention and criticism throughout the entire budget process due to the manner in which it was handled. Particularly troublesome to critics was the lack of coordination between the Prime Minister,s announcement of the withdrawal and statements to the contrary by the Ministry of Finance. However, they viewed the Finance Minister as handling the confusion graciously*noting his disagreement with the PM,s decision but ultimately respecting Netanyahu,s authority.

COMPETING ROLES OF PM AND MOF

110. (SBU) Commentators view the budget positively in light of the current economic situation, if only because it was necessary to approve the budget in order to execute broader economic plans. During the budget process, one of the more problematic issues that surfaced was that the Prime Minister essentially played the role of Minister for Economic Strategy, obviating the advisory role of Finance Minister Yuval Steinitz and his Ministry. Although Finance Ministry officials provide the PM with a set of proposals and alternatives, it is clear from the budget process that politicians made all the key decisions. A Bank of Israel contact said that it is good to have a Prime Minister who cares about economic matters, but acknowledged economists, concerns that the Finance Ministry,s role is now in question. Though there is still the common memory of Prime Minister Netanyahu,s strong and effective period as Finance Minister, he is viewed now as being more concerned about keeping his coalition together, and not necessarily doing what is right for the economy. The Finance Minister, on the other hand, is considered very intelligent and capable, but weak compared to Netanyahu, which does not bode well for the Finance Ministry.

111. (SBU) However, Netanyahu has also lost support through the process. Ha,aretz,s economic commentator, Nehemia Strassler, was an avid supporter of Netanyahu during his tenure as Finance Minister, approving of the reduction in taxes, fiscal consolidation, the change in culture from allowances to work, privatizations, and structural reforms which were all part of Netanyahu,s economic recovery plan. However, now, in a July 17 opinion piece in "Ha'aretz," Strassler was critical of how the budget and budget department of the Ministry of Finance were handled, and called the budget fat and wasteful. Strassler said this reflected Netanyahu,s weak leadership. A former Ministry of Finance official, now in the private sector, also

expressed concerns to Emboffs about the Government,s economic credibility. He noted that this is particularly problematic given that the government is only in its first year, and questions its future stability. There are also concerns about hidden concessions that might have been given to the Histadrut labor union as part of the package deal.

FINALLY A BUDGET... BUT FEARS OF INFLATION

¶12. The Ministry of Finance likes to emphasize that the budget and economic plan included components aimed at helping the economy pull out of the recession, assisting economy recovery and providing social assistance. The June CPI figures were released immediately following the budget approval, contributing to further doubts about economic plans. The increase of 0.9 percent was a surprise to most economists, and this could have been a statistical fluke, there are indications that CPI will continue to be high, due to the one percent increase in VAT, the drought tax, and increases in taxes on cigarettes, gasoline and alcohol. These increases are not necessarily inflationary and some may be temporary. However, they do pose an additional burden for weaker sectors of the economy. Given this, there are projections that the Bank of Israel will likely raise interest rates sooner than they might have otherwise*dampening some of the effects of economic recovery.

COMMENT

¶13. (SBU) This budget and the accompanying arrangements bill are a pale reflection of the "shock and awe" economic policy reforms Netanyahu's economic advisors promised Emboffs in conversations before the Israeli elections. However, given the realities of coalition politics and global recession, it will buy the government time to build support for a more focused fiscal policy in 2011.

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